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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1932

No.

ARTHUR M. BROWN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI to the United States Circuit Court of Appeals for the Ninth Circuit.

To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Honorable the Associate Justices of the Supreme Court of the United States:

Petitioner asks that the cause in the United States Circuit Court of Appeals for the Ninth Circuit, entitled and numbered, Arthur M. Brown, Petitioner,

vs. Commissioner of Internal Revenue, Respondent, No. 6812, be certified to this court for review of the judgment therein (for judgment see R. 274-283, reported in 63 F. (2d) 66). That judgment affirmed three orders of the United States Board of Tax Appeals assessing deficiencies as to petitioner's income taxes for 1923, 1925 and 1926 ("Findings and Opinion" of the Board,—R. 54-69; 22 B. T. A. 678. "Decisions" of the Board,—R. 70-72). In this behalf your petitioner respectfully shows:

I.

JURISDICTION, PROCEDURAL STEPS AND STATUTES RELATING THERETO.

(a) Petitioner, as an individual, made return for his income tax for 1923, 1925, and 1926. Respondent assessed deficiencies: $17,923.03 for 1923, by his "60 day letter" of Dec. 22, 1927 (R. 20-25), $1,520.19 for 1925, by his "60 day letter" of Apr. 28, 1928 (R. 35-37), and $944.30 for 1926, by his "60 day letter" of Feb. 7, 1929 (R. 47-52).

(b) In due time, pursuant to § 274 of the Revenue Acts 1924 and 1926 (43 Stat. 297, 44 Stat. 55; 26 U. S. C. § 1048), and § 272 of the Revenue Act of 1928 (45 Stat. 852; 26 U. S. C. § 2272), petitioner filed petitions with the Board of Tax Appeals, for redetermination of the deficiencies. The petitions were filed, as to the 1923 tax, on Feb. 20, 1928 (Docket No. 35305; R. 11-25), as to the 1925 tax, on Jun. 6, 1928 (Docket No. 39157; R. 26-37), and as to the 1926

tax, on Apr. 1, 1929 (Docket No. 43432; R. 39-52). Respondent filed answers on Apr. 20, 1928 (R. 25-26), Aug. 6, 1928 (R. 37-38), and May 31, 1929 (R. 52-53). All three matters were set for hearing on May 14, 1930 (R. 1, 5, 8). At that time they were consolidated (R. 114-115). On Mar. 11, 1931 the Board promulgated its "Findings of Fact and Opinion" (R. 54-69; 115; 2, 5, 9). On Apr. 25, 1931, decisions, pursuant to the findings and opinion, were entered, redetermining the deficiencies in petitioner's taxes in the same amounts as assessed by respondent (R. 70-72; 2, 5-6, 9; 115).

(c) Agreeably to the Acts of Congress (Act of Feb. 26, 1926, §§1001 (as amended by Act of May 29, 1928, §603, 45 Stat. 873), 1002, 1003, and 1005, 44 Stat. 109-110; 26 U. S. C. §§1224-1228), and to Rule 38 of the Circuit Court of Appeals, for the Ninth Circuit, petitioner, being an inhabitant of the Ninth Circuit, petitioned that court to review said decisions. Separate petitions, containing assignments of error, were filed in each matter on Sept. 8, 1931 (R. 80-91; 93-101; 103-112), and notice duly given (R. 91-92; 102-103; 112-113). Pursuant to stipulations that the three matters might be consolidated for review and presented on one record (R. 73-80; 115), petitioner had settled and filed his "Consolidated Statement of Evidence" (R. 114-263). A single transcript was prepared. Pursuant to stipulation and order exhibits not set out in the statement of evidence were omitted in printing the record, with leave to refer to any matters in unprinted exhibits if set out in the briefs (R. 268-269).

(d) On Feb. 6, 1933 the Circuit Court of Appeals, for the Ninth Circuit, affirmed the orders of the Board (R. 282-283). On Mar. 8, 1933 and within the time allowed by Rule 29 of that court, that "a petition for rehearing may be presented within 30 days after judgment", petitioner filed, in that court, his petition for rehearing (R. 283). That petition was denied on Mar. 21, 1933 (R. 283).

Petitioner, agreeably to §1003 of the Act of Feb. 26, 1926 (44 Stat. 110; 26 U. S. C. §1226), §240 of the Judicial Code (36 Stat. 1157, as amended by 43 Stat. 938; 28 U. S. C. §347), and §8 of the Act of Feb. 13, 1925 (43 Stat. 940; 28 U. S. C. §350), asks that, upon certiorari, the judgment of the Circuit Court of Appeals, for the Ninth Circuit, be reviewed.

II.

ISSUES AND STATUTES INVOLVED.

The question for 1923, 1925 and 1926 is the proper method of returning "overriding commission" income from an insurance general agency business, and, particularly, is as to the proper year in which to deduct "overriding commission" received *but unearned and refunded.* Admittedly this item is to be deducted in computing income—the question is as to the method of return as throwing this item into one year or another. For 1923 there is an additional matter—whether a payment made to petitioner's sister under a written contract may be subtracted in computing taxable income.

The statutes involved are provisions of the Revenue Acts of 1921, 1924 and 1926 (since carried into the Revenue Acts of 1928 and 1932. Reference is made to the perpetuating provisions. The matters here presented are not as to provisions which have been discarded.) The quotations are taken from Title 26, U. S. Code, except as to the Act of 1921.

(a) Revenue Act of 1921, §200 (4), (42 Stat. 227; Fed. Stat. Ann. 1921, 123) provided:

> "The term 'paid' for the purposes of deductions and credit under this title, means 'paid or accrued' or 'paid or incurred', and the terms 'paid or incurred' and 'paid or accrued' *shall be construed according to the method of accounting upon the basis of which the net income is computed under § 212.*"

The Revenue Acts of 1924 and 1926, §200 (d) (43 Stat. 254, 44 Stat. 10; Fed. Stat. Ann., 1924, 82; 26 U. S. C., §931) provided:

> *"The terms 'paid or incurred' and 'paid or accrued', shall be construed according to the method of computing upon the basis of which the net income is computed* under §953 or §984. The deductions and credits provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid *or incurred', dependent upon the method of accounting* upon the basis of which the net income is computed under §953 or §984, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

(See Revenue Acts of 1928 and 1932, §§43, 48 (c); 45 Stat. 805, 807; 26 U. S. C., §§2043,

2048; 47 Stat. 185, 187, 26 U. S. C., §§3043, 3048.)

(b) Revenue Acts of 1921, 1924 and 1926, §212 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 133; 43 Stat. 267, Fed. Stat. Ann. 1924, 94; 44 Stat. 23, 26 U. S. C. § 953) provided:

"(a) In the case of an individual the term 'net income' means the gross income as defined in section 954 of this title, less the deductions allowed by sections 937 and 955.

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period, (fiscal year or calendar year, as the case may be) *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."

(See Revenue Acts of 1928 and 1932, §§21, 41; 45 Stat. 797, 805, 26 U. S. C., §§2021, 2041; 47 Stat. 178, 185, 26 U. S. C., §§3021, 3041.)

(c) Revenue Acts of 1921, 1924 and 1926, §213 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 134; 43 Stat. 267, Fed. Stat. Ann. 1924, 95; 44 Stat. 23, 26 U. S. C., §954), after specifying items included in gross income, provided:

"The amount of all such items shall be included in the gross income for the taxable year in which

received by the taxpayer *unless, under methods of accounting permitted under subdivision* (b) *of section 953, any such amounts are to be properly accounted for as of a different period.*"

(See Revenue Acts of 1928 and 1932, §42; 45 Stat. 805, 26 U. S. C., §2042; 47 Stat. 185, 26 U. S. C., §3042.)

(d) Revenue Acts of 1921, 1924 and 1926, §214 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 135; 43 Stat. 269, Fed. Stat. Ann. 1924, 97; 44 Stat. 26, 26 U. S. C., §955) provided:

"(a) In computing the net income there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid *or incurred* during the taxable year in carrying on any trade or business, * * *."

(See Revenue Acts of 1928 and 1932, §23; 45 Stat. 799, 26 U. S. C., §2023; 47 Stat. 179, 26 U. S. C., §3023).

(e) In connection with the above, see Regulations 69, Art. 21-24, 36, 91, 1523, 112; Regulations 74 and 77, Art. 41 (a), 321-323, 334, 335, 341, 342.

III.

SUMMARY STATEMENT OF FACTS.

(a) The income is from an insurance general agency business, conducted under the name of Edward Brown & Sons. There is a question as to the interest in this business of one daughter of Edward Brown (a

sister of petitioner). This is noticed below. Aside from such interest, the proprietors of this business were:

From 1896 to 1904 Edward Brown and his two sons, Arthur M. Brown, your petitioner, and Herbert H. Brown; from 1904, when Edward Brown died, until August 1922, when Herbert H. Brown died, Arthur M. Brown and Herbert H. Brown; from the death of Herbert H. Brown to Jan. 1, 1924, petitioner as sole proprietor; from Jan. 1, 1924, petitioner and his son, Arthur M. Brown, Jr. (R. 125, 130, 131, 56). The income involved is, then, the income of petitioner doing business as Edward Brown & Sons, for 1923, and petitioner's share of the partnership income of petitioner and his son, doing business as Edward Brown & Sons, for 1925 and 1926.

(b) An insurance general agent is a wholesaler of insurance, and, in a given territory, is manager for the insurance company represented. The local agent solicits and procures the business to be written. His functions then cease. Here the general agent's functions begin. His duties are performed, as to each policy, throughout its life. Policies are written for one, three or five years. The general agent represents his company generally, and attends to all of its affairs. At every moment while policies are current he has duties as to those policies. Details of the duties and functions of the general agent will be found in the Opinion of the Circuit Court of Appeals, 63 F. (2d) 66, R. 277-278, in the Findings and Opinion of the Board, 22 B. T. A. 678, R. 60, 61, and in even greater detail in the evidence, R. 168-179. For distinction be-

tween local agent and general agent see R. 125, 167-169.

(c) The compensation of the local agent is a policy commission, or commission for getting business. It is fixed by an independent organization, the Board of Underwriters (R. 126). By statute in many of the states in which Edward Brown & Sons operated, it was required that policies be countersigned by a resident agent, who "shall receive the full commission when the premium is paid".

Idaho, Compiled Statutes, §5009, Statutes of 1915, Chapter 145, §2, p. 318, (R. 167);

California, Political Code, §633d;

Province of British Columbia, Insurance Act, Acts of 1925, Chapter 20; 1926-1927, Chapter 35; 1928, Chapter 19, consolidated as the Insurance Act, August 17, 1928, §§149, 160, 183-186, 197;

Nevada Revised Laws, §1304, as amended by Statutes 1919, 392;

Montana Code, §6118, Insurance Laws of the State of Montana, Compiled by Insurance Department, 1929, p. 29;

Wyoming, Insurance Laws, §11, Laws 1921, Chapter 142, §3;

Oregon, Insurance Laws, §4, Olson, Oregon Laws, §6333, Laws 1923, Chapter 115, §1, p. 172.

Whether such statutes were in force or not, the same rule was followed by Edward Brown & Sons. The local agent received the policy commission (R. 167, 168).

The compensation of the general agent is fixed by contract between himself and the company. Edward Brown & Sons represented six fire insurance companies. Relations with four of the companies were defined by writings (Petitioner's Exhibits 5, 6, and 7, R. 131-165); with two by conversations and course of dealing. The business of all companies was conducted in the same way—the same functions were performed for each—relations different only as to rate of compensation paid (R. 165, 166).

(d) The compensation received by Edward Brown & Sons recognizes the time element which entered into its earning, and that it was earned only over the periods of the lives of the policies written through Edward Brown & Sons.

The general agent received a contingent "commission"—a percentage of the net earnings, if any, on the business written through the general agent (as to which there is no question)—and an "overriding commission"—a percentage of the *net* premiums on business written through the general agent. Net premiums are gross premiums, less cancellations (by the company or by the assured), and less net reinsurance effected (R. 246, 247, 257, 166 and Petitioner's Exhibits 5, 6 and 7).

Where a premium is paid, the general agent retains his overriding commission on remitting to the company. On cancellation of a policy the general agent, whether during the currency of the agency or afterwards, must return the unearned compensation

—the part proportionate to the return premium (see Petitioner's Exhibits 5, 6 and 7 and R. 179). This result follows, without express provision to that end, where compensation is a percentage of *net* premiums. It requires return of unearned "overriding commission", even after termination of the agency relationship (*Milwaukee Mechanics Ins. Co. v. Warren,* 155 Cal. 346; *National Union Fire Ins. Co. v. Mason,* 21 Cal. App. 297). During the tax years here in question the general agency of Edward Brown & Sons for United States Merchants & Insurance Shippers Company was terminated. Edward Brown & Sons, pursuant to this rule, was required to repay, and did, repay the portions of compensation received which related to the unearned premium (R. 179).

The overriding commission of the general agent (unlike the policy commission of the local agent, which is earned when the business is written) is only a percentage of the premium income of the company, and, like that premium income, is earned only over the life of the policy. If the policy is prematurely terminated, a proportionate and proper refund must be made. This is known as "return commission".

(e) From long experience, the ratio of cancellations to business written can be predicted, and the relation of return commission to gross commission received accurately fixed. Edward Brown & Sons' own experience showed the proportion of overriding commission on business written in any year (whether for one, three or five years), of which return would have to be made.

Five Year Period	Gross Fire Premiums Written	Fire Premiums Cancelled	Ratio
1919 to 1923	$14,893,022	$3,333,104	22.38%
1920 to 1924	15,647,482	3,492,101	22.32
1921 to 1925	15,931,443	3,432,670	21.55
1922 to 1926	17,155,359	3,642,071	21.13

(Petitioner's Exhibits Nos. 28-32.)

In the fire insurance business, generally, cancellations run from 20% to 25% (R. 206).

(f) In 1902 Edward Brown, Herbert Brown, and petitioner entered into an agreement in writing defining their respective interests, and providing:

> "Before any division of profits is made the said partners agree to pay monthly to Jessie H. Jones, Edith H. Halton and Ethel Brown (the three daughters of Edward Brown and sisters of Arthur M. and Herbert H. Brown) the sum of Two Hundred Fifty (250) Dollars, and, Further, whenever the net income from the business of the said firm shall exceed the sum of Eighteen Thousand (18,000) Dollars per annum, they will pay a one sixth (1/6) proportion of such excess to the said Jessie H. Jones, Edith H. Halton and Ethel Brown."
>
> (Petitioner's Exhibit 3, R. 127.)

The agreement then provided for payment to the heirs and executors of the three partners in the event of death of any of them. In 1905, following the death of Edward Brown, there was another agreement which could not be found (R. 129). In 1907, one of

the sisters having died, Mrs. Halton and Mrs. Crandall made the agreement here in question as a substitution for the previous agreement. This agreement has never been modified (R. 128-130). It provided that Mrs. Halton and Mrs. Crandall agreed "to accept from the firm of Edward Brown & Sons * * * the sum of Two Hundred and Fifty Dollars ($250) per month, commencing with the month beginning June 1, 1907, and ending only by mutual agreement in full satisfaction of all amounts which may be due, or may become due to us, or either of us, or the survivor of us, from said firm, * * * " (Petitioner's Exhibit 4, R. 129-130). Petitioner, pursuant to this agreement, paid $3,000 to Mrs. Halton in 1923. The partnership returns for 1925 and 1926 showed that in those years, and as a partner's share, Mrs. Halton received $3,000 and $2,200 (Petitioner's Exhibits 11 and 13).

IV.

METHODS OF ACCOUNTING AND MAKING RETURN.

(a) The books of Edward Brown & Sons were kept on an accrual basis (R. 195, 251, 257). The Board so found (R. 63). This is the standard and accepted method for insurance general agents (R. 251). The method of accounting has never been changed. The methods of return hereafter noticed, however they may differ, required no change in method of accounting or method of keeping the books, nor the changing of any figure on those books (R. 201, 211, 250-252).

(b) Until 1923 return of overriding commission was made by returning overriding commission received in any one year, less return commission on cancellations effected in that year. Policies were written for 1, 3 and 5 years. This resulted in charging against overriding commission received in one year on business written in that year, and from premiums paid in that year, return commission returned in that year, on cancellation of business written in an earlier year, where the commission, a part of which was returned, was received in the earlier year from a premium received in an earlier year. *Under this method return commissions were charged, not against the commissions and the year to which the same related, but against later years.* In the case of return commission relating to policies written for the United States Merchants & Shippers Insurance Company, after termination of the agency for that company, such method would charge return commission, not against that company and the policies to which the same related, but against commissions received on different policies written for wholly different companies.

(c) For 1923, the first year in which petitioner was sole proprietor of the business, conceiving that this method was inaccurate, and that the return commission should be charged against the very commissions which were being returned, and as a charge properly attributable to the process of earning those commissions, during the period in which they were received (cf. *U. S. v. Anderson*, 269 U. S. 422, 70 L. ed.

347 and Reg. 69, Art. 112, Reg. 74 and 77 Art. 342), petitioner, set up a figure on his books (Petitioner's Exhibit No. 31), dictated by past experience as to cancellations and return commission (see paragraph III (e) above), representing the liability to return commission, by reason of future cancellations of 1923 business. This was deducted from the commission received in 1923 in making return. This method was followed for subsequent years. Under this method return commission on account of cancellation of policies written in 1923, where the cancellation occurred in later years, was charged, not against the commissions received from other policies written in the year of cancellation, but against this reserve. This procedure was followed for later years. The amount of this reserve for 1923 was $52,971.96. The net additions to the reserve for 1925 and 1926 were $3,292.98 and $1,947.77. With the exception of the $3,000 paid to Mrs. Halton in 1923 (see below), these figures are the figures in dispute. The disallowance of these figures gave rise to the deficiencies assessed (R. 245-247). Returns made under this method were made in accordance with the books and on the same basis as that upon which the books had been kept (R. 232-234).

(d) Before the Board petitioner urged a third method, suggested to him by Acts of Congress. This was to return in each year only the compensation earned in that year, computed not by taking compensation received, less a figure representing the obligation to return a part of it on cancellation of policies, which

figure was determined by past experience of cancellation, but by taking the actual policies in force in a given year (whether written in that year or not), computing the premiums earned *in the year,* and arriving at the compensation earned in any year. Petitioner urged that the return be made on a basis of compensation earned by pro-rating the "overriding commission" over the life of each policy on a strict actuarial basis. Exhibits showing the precise figures for petitioner's income on such basis, for the years 1923, 1925 and 1926, are in evidence, and show that the deficiency assessed was improper (Petitioner's Exhibits 20-28).

V.

ACTION OF THE COMMISSIONER AND THE BOARD.

(a) The respondent and the Board of Tax Appeals refused to permit petitioner to return his income for 1923, or his share of the partnership income of Edward Brown & Sons for 1925 and 1926 in accordance with either of the methods referred to in paragraph IV (c), or in IV (d) above, but required him to make his return in accordance with the method in paragraph IV (b) above, with resulting deficiencies. While the books are kept on an accrual basis, petitioner is forced to make return as to certain disbursements on a cash basis.

(b) As to 1925 and 1926 respondent permitted deduction of the payments made to Mrs. Halton pursuant to the agreement set out in paragraph III (f) above, but refused to permit this for 1923.

VI.

DECISION OF THE CIRCUIT COURT OF APPEALS AND REASONS WHY THAT DECISION SHOULD BE REVIEWED.

(a) The Circuit Court of Appeals in affirming the orders of the Board announced, as the grounds for its decision, the following:

1. The payment to Mrs. Halton was not allowed as a deduction because the court was unable to determine what interest, if any, she had in the business, as a partner, or that she rendered any service which would authorize allowance of the item as a business expenditure (R. 276-277).

2. As to the overriding commission income it was said that money subject to one's disposition should be returned in the year in which received, "and not at some indefinite future time of his own selection"; that the method urged by petitioner would make the collection of revenues uncertain and force the Government to gamble on the taxpayer's solvency; that reserves, such as set up, are to cover contingent liabilities and are not authorized as deductions. The concurring opinion as an added ground states that, "it will make no difference in the long run to the petitioner whether the return commissions due to cancelled policies are deducted from the revenue of the current year or from a contingent fund set up" (R. 279, 281).

(b) The determination of the Circuit Court of Appeals as to the Halton matter should be reviewed for the following reasons:

1. The Circuit Court of Appeals has decided an important question of federal law, which has not been, but which should be, settled by this court. It has held that where a person, entitled to participate in the income of a business, as a matter of original participation therein, under a writing, receives his participation, still, unless the person to whom such payment is made performed services, as the consideration for that participation, or sustained the conventional relation of partner of the persons actively conducting the business, the amount paid is to be included in the gross income of the active proprietors of the business and taxed to them. It has indicated that the only proprietors of a business to whom income is to be taxed are those who (1) perform services, or (2) sustain the conventional relation of partners.

2. The holding is in conflict with the reasoning and holding of the Circuit Court of Appeals for the Sixth Circuit in *Commissioner of Internal Revenue v. Olds*, 60 F. (2d) 252.

(c) The determination of the Circuit Court of Appeals as to the method of handling return commissions should be reviewed for the following reasons:

1. The question here presented is not peculiar to petitioner. It is one of general concern. It is a question which presents itself in exactly the same way as to all insurance general agents. But more than that, the same question presents itself to all persons who, accounting on an *accrual* basis, receive money as to which there is an obligation to return a part, and where repayment, though conditional as to any par-

ticular component part of the whole, is not uncertain as to the total amount of return, but the total amount to be returned can be fixed on the basis of experience.

2. The decision of the Circuit Court of Appeals is in conflict with applicable decisions of this court, notably:

U. S. v. Anderson, 269 U. S. 422, 70 L. ed. 347;
American National Company v. U. S., 274 U. S. 99, 71 L. ed. 946;
Niles Bement Pond Co. v. U. S., 281 U. S. 357, 74 L. ed. 901;
Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 75 L. ed. 234;
Continental Tie & Lumber Co. v. U. S., 286 U. S. 290, 76 L. ed. 1111.

And if it be said that the principles of these cases are not controlling, then—

3. The court below has decided an important question of federal law, which has not been, but which should be, settled by this court.

4. The determination of the court below as to reasoning and result is in conflict with the reasoning and result of the Circuit Court of Appeals for the Fourth Circuit in

Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue, 56 F. (2d) 1028;

and also the reasoning and holding in

Alpha Portland Cement Co. v. U. S., 76 Ct. Cls. 680, followed in

La Salle Cement Co. v. Commissioner of Internal Revenue, 59 F. (2d) 361, 362-363 (C. C. A. 7).

Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue, supra, expressly disapproves a line of cases in the Board of Tax Appeals, two of which are relied upon by the Circuit Court of Appeals in its opinion—*Jackson Casket & Mfg. Co.,* 7 B. T. A. 1190 and *Landesman v. Hirschheimer Co.,* 15 B. T. A. 604.

WHEREFORE, your petitioner prays that a writ of certiorari issue under the seal of this court, directed to the Circuit Court of Appeals for the Ninth Circuit, commanding that court to certify and forward to this Court a full transcript of the record and proceedings in the cause, to the end that this cause may be reviewed and determined by this court, and that the judgment of the Circuit Court of Appeals herein be reversed, and for such other relief as, the premises considered, is proper.

Dated: June 12th, 1933.

PETER F. DUNNE,
Counsel for Petitioner.

ARTHUR B. DUNNE,
J. ELLIOTT COOK,
Of Counsel.

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1932

No.....

ARTHUR M. BROWN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF
in Support of Petition for Writ of Certiorari.

Reference has already been made to the opinion below (p. 2 of the Petition) and to the procedural steps and statutes upon which the jurisdiction of this court rests (Pet. Par. I, particularly Subd. (d)). The facts have been stated (Pet. Pars. III, IV, V, and VI(a)).

SPECIFICATION OF ERRORS.

The court below erred in that while the books of petitioner were kept on an accrual basis, petitioner is

required to account for return overriding commission income on a cash receipt and disbursement basis; it erred in refusing to permit the petitioner to deduct, in ascertaining taxable income, a liability incurred in the years in question to return overriding commission received upon cancellation of policies to which the same related, where the amount of such return commission could be ascertained from the past experience of the business.

The court below erred in determining that to set up a fund to meet a liability incurred, the amount of which is determinable from experience of the business, is not countenanced by the statutes even where the books are kept on an accrual basis. It erred in not permitting petitioner to return income only as earned, on a strict actuarial basis, if the basis selected by him in making his return was improper. It erred in determining that overriding commission of petitioner was earned when received, and must be returned for the year in which received, where books were kept on the accrual basis.

The lower court erred in determining that the $3,000 paid to Mrs. Halton was not paid to her by way of original participation in the profits of the business, and in holding that the same was taxable to the active proprietor or proprietors of the business.

In this regard, reference is also made to paragraphs VI(b) and VI(c) of the petition, and to the petitions for review (R. 86-89; 97-100; 108-110).

ARGUMENT.

I.

RETURN OF OVERRIDING COMMISSION.

Under the income tax statutes, gains and losses for tax purposes are computed for annual periods, and deductions are taken in the year in which the same are sustained—"paid or incurred" (see Statutes, Par. II of Pet.).

Martin v. Commissioner of Internal Revenue, 61 F. (2d) 942, 944 (C. C. A. 2);

Burnet v. Sanford Brooks Co., 282 U. S. 259, 75 L. ed. 383;

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

U. S. v. Anderson, 269 U. S. 422, 70 L. ed. 347.

The basic principle is that the return shall be made in such a way as to clearly reflect the truly taxable income. To this end, the taxing statutes have been amended from time to time. The most fundamental changes were those made by the Acts of 1916 and 1918. The first permitted the taxpayer to make his return on a basis other than cash receipts and disbursements if his accounts were kept on such other basis. The second, and the later acts, make it mandatory for taxpayers to use their bookkeeping basis as the basis for making their return. The effect of these statutes was the introduction of the accrual method as a basis for making return.

Niles Bement Pond Co. v. U. S., 280 U. S. 357, 74 L. ed. 901;

Aluminum Castings Co. v. Routzahn, 24 F. (2d) 230; 31 F. (2d) 669 (C. C. A. 6), 282 U. S. 92, 75 L. ed. 234.

The purpose of the change, and of permitting returns "in accordance with the method of accounting regularly employed in keeping the books" of the taxpayer (and consequently in accordance with the accrual basis where such was the basis for keeping the books), "was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses INCURRED *in and properly attributable to the process of earning income during that period.*"

U. S. v. Anderson, supra;
Aluminum Casting Co. v. Routzahn, supra;
Niles Bement Pond Co. v. U. S., supra;
Miller & Vidor Lumber Co. v. Commissioner of Internal Revenue, 39 F. (2d) 890 (C. C. A. 5);
Reg. 69, Art. 24; Reg. 74, Art. 323;
Reg. 69, Art. 22; Reg. 74, Art. 321;
Reg. 69, Art. 23; Reg. 74, Art. 322.

It is the essence of the accrual system that income due and accrued, though not yet paid, be treated as received. Correspondingly, it is proper to charge against income any item of outgo incurred in the year in question, and attributable to the process of procuring the income of the year in question, even though the outgo will not be paid until a later time.

This is true even where the exact amount of the outgo is uncertain, provided that from past experience the amount of that outgo can be fixed with reasonable accuracy.

U. S. v. Anderson, supra;

American National Co. v. U. S., 274 U. S. 91, 71 L. ed. 946;

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

Continental Tie & Lumber Co. v. U. S., 286 U. S. 290, 76 L. ed. 1111;

Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue, 56 F. (2d) 1028 (C. C. A. 4);

Alpha Portland Cement Co. v. U. S., 67 Ct. Cls. 680;

La Salle Cement Co. v. Commissioner of Internal Revenue, 59 F. (2d) 361, 362-363 (C. C. A. 7);

Klein, Federal Income Taxation, 106, 130-137.

Where the total income and outgo is made up of a multitude of small items, and where the gross result of all of the items can be accurately foretold on the basis of experience, the foregoing rule applies even where there may be uncertainty as to what particular component items will ultimately enter into the final figure.

"Even though there be contingencies as to any particular account, if the experience of the company is such that upon the accounts taken as a

whole it is possible to predict with substantial accuracy what the discount will be, a deduction in anticipation of same should be allowed. It is the total of the accounts which is considered in computing income, and, if the discount which will be allowed from this total can be determined with reasonable certainty, there is no reason why the same should not be deducted."

Virginia-Lincoln Furniture Corp. v. Commissioner of Internal Revenue, supra.

This court expressed the rule in *Lucas v. American Code Co.,* supra, as follows:

"Generally speaking, the income tax law is concerned only with realized losses, as with realized gains. Exception is made, however, in the case of losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduction, in certain circumstances, before they are absolutely realized. * * * It may be assumed that, since the company kept its books on the accrual basis, the mere fact that the exact amount of the liability had not been definitely fixed in 1919 did not prevent the deduction as a loss of that year of the amount later paid."

Manifestly, when at the moment overriding commission income was received, an obligation was incurred to return part of it upon cancellation of the policies to which the same related, that commission was not the petitioner's to do with as he pleased. He was not that much richer. If he were to honestly meet his obligations, he could not spend that money.

As matter of sound accounting and business, he must set aside a sum equivalent to what his experience told him must be returned. His legal duty was to keep himself in condition to perform his obligation to refund return commission. The obligation to return commission in 1924, for example, on policies written in 1923 but cancelled in 1924, is clearly attributable to the receipt of commission in 1923, and is a proper charge against the receipt of that commission.

One peculiar result of the method insisted upon by the Commissioner, and sanctioned by the court below, after a general agent has ceased to do business with one company, has already been pointed out (see Pet., Par. IV (b)). Another example will point the impropriety of this method. Assume that petitioner received overriding commission income for business written in 1923. Certainly he is not to pay a tax on the part of that which is returned on cancellations. But assume that he goes out of the general agency business at the end of 1923. Since his commissions are on net premiums, he will still be required to make return on cancellation of policies (*Milwaukee Mechanics Ins. Co. v. Warren,* 155 Cal. 346; *National Union Fire Ins. Co. v. Mason,* 21 Cal. App. 297). But if he has not been permitted to set up a reserve, in 1923, against which to charge these return commissions, against what are they to be charged after he has gone out of business and is no longer in receipt of income?

The Regulations have, in several instances, recognized the propriety of setting up reserves to take

care of future contingencies related to the income against which the reserves are charged. Thus reserves for bad debts are permitted (Reg. 69, Arts. 151-155; Reg. 74, Arts. 191-195). Again, special provision has been made in the case of long term contracts (Reg. 69, Art. 36; Reg. 74, Art. 334). Compare the situation with installment sales contracts (Reg. 69, Arts. 23, 42; Reg. 74, Arts. 322, 351). The permitting of reserves for redemption of trading stamps given on purchase of articles is in strict analogy to the situation here (Reg. 69, Art. 91; Reg. 74, Art. 335).

The following cases, already noticed, deal directly with the question of reserves, related to the income against which the reserve is charged, made up of a number of small items from out of a greater number of items, the amount of which is dictated by experience.

Virginia-Lincoln Furniture Co. v. Commissioner of Internal Revenue, supra;

Alpha Portland Cement Co. v. U. S., supra;

La Salle Cement Co. v. Commissioner of Internal Revenue, supra.

Against these considerations and authorities, it is first suggested by the court that the taxpayer should account for income in the year in which he received it and not at some indefinite future time of his own selection. If it is meant that income received must be returned, without deduction for liabilities concurrently incurred although not yet paid, the statement, we say with deference, is inaccurate and in conflict with the decisions of this court, where the books are

kept on the accrual basis. As to the implication that the petitioner here is seeking to return his income "at some indefinite future time of his own selection", there are several answers. Whether the return be made by returning income received less a reserve as suggested in the petition, paragraph IV (c), or be returned on a strict pro rata and actuarial basis, as earned, as suggested in paragraph IV (d) of the petition, the income will not be returned at some future and indefinite time, but the time and amount of returned is dictated strictly by consideration of the life of the insurance policies to which the commission relates. *The time and method selected by the petitioner, far from being indefinite and of his own selection, are the exact methods which Congress prescribed for fire insurance companies.*

Through the Revenue Act of 1918, fire insurance companies were required to return their income, as other corporations did, except that Section 12 (39 Stat., 767, as amended; Fed. Stat. Ann. 1918, 329) specifically permitted deduction "in the case of fire insurance companies" of "the net addition, if any, required by law to be made within the year to reserve funds". This court has held that, "unearned premium reserve" is a familiar type of insurance reserve and a strictly technical reserve within the meaning of this statute (*Maryland Casualty Co. v. U. S.*, 251 U. S. 342, 64 L. ed. 297, decided under the Act of 1913). Our overriding commission income is merely a percentage of the premium income of the companies, and our unearned overriding commission re-

serve is merely a percentage of the unearned premium reserve of the companies themselves. The companies set up a reserve for premiums which must be returned, and we set up a reserve which is a percentage of that, for our share—the return commission. Our income is a percentage of that of the insurance companies, it is earned over the life of the policies, and we returned it in the same way that Congress had the insurance companies return their income.

The second method of return suggested by petitioner to the Board (par. IV(d) of the petition) was likewise suggested by an Act of Congress. In 1921 Congress determined that in the case of fire insurance companies it would be more accurate to have premium income returned on a pro rata basis, returning the income actually earned within the year. Accordingly, by § 246 of the Revenue Act of 1921, it was provided that companies other than mutual and life should make return on the following basis: Return as gross income "the combined gross amount earned during year, from investment income and from underwriting income * * *." The Act then proceeded as follows:

> "The term 'underwriting income' means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;
>
> "The term 'premiums earned on insurance contracts during the taxable year' means an amount computed as follows:
>
> "From the amount of gross premiums written on insurance contracts during the taxable year deduct return premiums and premiums paid for re-

> insurance. To the result obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year."

This statute was carried into the later acts. See 26 U. S. C., § 1006 (Revenue Act of 1924 and 1926, § 246, 43 Stat. 290, and 44 Stat. 48), 26 U. S. C., § 2204 (Revenue Act of 1928, § 204, 45 Stat. 844), 26 U. S. C., § 3204 (Revenue Act of 1932, § 204, 47 Stat. 225).

These statutes in terms apply only to insurance companies, not to general agencies. But Congress has determined what, as a matter of fact, will truly reflect underwriting income. That method, as a matter of fact, will just as truly reflect an income which is only a percentage of the premium income of the insurance companies.

Next, the opinion states that the practice urged by us would make the collection of revenues uncertain and make the Government gamble upon the continued solvency of a taxpayer. If this is true, the history of the various tax statutes will indicate that this is a risk that Congress has been willing to take. But we say with deference, that the statement is not accurate. If a proper method of return shows that the Government is entitled, in a particular year, to only a given amount as tax, that in itself is a complete answer. If, in arriving at the amount of the income to be taxed, allowance is made for obligations owed to third persons, and if the taxpayer does not in fact meet those

obligations in the future, the loss is not that of the Government but of the obligees.

Finally, it is said that reserves to cover contingent liabilities are not allowed as deductions unless sanctioned by statute. The cases upon which we rely, as indicating that such a reserve as was sought to be set up here is properly allowable, have already been noticed. It remains only to say that an analysis of the cases cited will not support the holding of the court here.

Three of the cases cited and relied upon were cases of an attempt to deduct an amount as a "reserve" against a single isolated and *disputed* claim, and this reserve was attempted to be set up in advance of determination of either liability itself or the amount of any liability.

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

Consolidated T. Co. v. Bowers, 19 F. (2d) 382 (D. C.);

Lane Construction Corp., 17 B. T. A. 826, 49 F. (2d) 1080 (C. C. A. 2).

The *Lucas Case* is expressly distinguished in *Virginia-Lincoln Furniture Co. v. Commissioner*, supra.

Spring Canyon Coal Co. v. Commissioner, 43 F. (2d) 78 (C. C. A. 10) was an attempt to deduct a so-called "reserve" to meet possible liability on tort claims, where, in truth, the facts—the accidents—upon which such claims might be predicated, had not yet occurred.

Highland Milk Condensing Co. v. Phillips, 34 F. (2d) 777 (C. C. A. 3), was an attempt to deduct repayments made to buyers of merchandise to protect them against a declining market. There was no past experience for such a deduction, either as to amount, time, or necessity. It was a single, isolated, and unusual matter.

Earle v. Commissioner, 38 F. (2d) 965 (C. C. A. 1), did not involve any question of deductions for liabilities, contingent or otherwise, but presented a question as to the proper method of return of a partner's distributive share upon dissolution of the partnership by death.

William J. Ostheimer, 1 B. T. A. 18, has little to recommend it, and is believed out of harmony with the views of this court. Be that as it may, the case has no analogy here. There a reserve to meet a possible liability to return leased chattels in as good condition as when they were let, was set up because the lessee was faced with the impossibility of the renewal of the lease due to national prohibition. No basis for the "reserve" was shown. It is to be noticed that one member of the Board of Tax Appeals dissented.

Thomas Cronin Co. v. Lewellyn, 9 F. (2d) 974 (D. C.) and *Uvalde Co.,* 1 B. T. A. 932, involved street paving contracts. The contractor was paid at the completion of his work. According to his contract he was required to repair any defects which might appear within a stated length of time. Accordingly, he set up a fund sought to be deducted to meet the anticipated expenses. It was held that this was not a proper de-

duction. The amounts were apparently based on pure estimate, and it was found that it was impossible on any basis to determine the amount necessary to be deducted. In addition, it is to be noticed, that if the contract were properly performed in the first instance, there would be no defects and no expense of repair. This is expressly pointed out in the *Thomas Cronin Co. Case.* These cases have been severely commented on by text writers. See *Montgomery, Income Tax Procedure,* 1927 Ed. 239, 241, 244, 265 and 268; *Klein, Federal Income Tax,* 137 (quoted with approval in *Virginia-Lincoln Furniture Corp. v. Commissioner,* supra), stating that "it is unthinkable that a higher tribunal, or the Board itself, will not change the situation sooner or later".

The other two authorities cited are *Jackson Casket & Mfg. Co.,* 7 B. T. A. 1190, and *Landesman-Hirschheimer Co.,* 15 B. T. A. 604. These are discount cases —customers were permitted a discount on performance of certain conditions. A reserve was set up to meet this discount. This reserve was disallowed. But this line of cases did not stop here. It was continued, and the rule of these cases followed in the *Virginia Table Case,* another discount case. This case was appealed to the Circuit Court of Appeals for the Fourth Circuit as *Virginia-Lincoln Furniture Corp. v. Commissioner,* 56 F. (2d) 1028, to which reference has been made several times. The court reversed the Board of Tax Appeals, and expressly disapproved this line of cases in the Board. The order in the *Landesman-Hirschheimer Co. Case* was affirmed

on appeal, but this was solely upon the ground that the record was incomplete (44 F. (2d) 521—C. C. A. 6.)

In the concurring opinion it is first suggested that we are not entitled to deduct a reserve, and also the premiums actually returned. This is conceded, and the exhibits put into the record, by the petitioner should show adjustments to prevent duplicate deduction (see *Virginia-Lincoln Furniture Corp. v. Commissioner,* handling a similar situation). It is also said that if the deductions sought to be taken are reasonable, it will make no difference in the long run how the returns are made—whether on the basis insisted upon by respondent, or on the basis insisted upon by petitioner. It is believed that this suggestion falls into error in two respects. In the first place, it is necessary to allocate income properly to the various years because of the tax rates. They vary from year to year, and are graduated according to amount of income. In the second place, "income taxes are levied upon the net income for an annual accounting period. Gains in one period may not be offset by losses in another" (*Earle v. Commissioner,* supra). And if the suggestion is correct it cuts both ways—it applies equally to the Government. It indicates that the method we suggest will not unduly prejudice the Government, and, accordingly, there is no practical reason for not permitting a return in accordance with the proper construction of the statute.

The opinion in *Virginia-Lincoln Furniture Corp. v. Commissioner,* 56 F. (2d) 1028, is very full. The

court in that opinion does not merely announce a result—it argues the matter out. We respectfully direct attention to that case.

II.

THE HALTON MATTER.

The Commissioner rejected the payment made to Mrs. Halton upon the ground that it was a capital expenditure. The Board does not approve this. To the contrary, it says, "Nor can we say * ** that the amount * * * was a capital expenditure" (R. 65).

There is not a word to show that the payment was in fact a capital expenditure. There is a showing that by reason of a contract Mrs. Halton was given a participation in the business. What the consideration for that contract was is immaterial—indeed, had her interest as a proprietor in the business been given to her as a gratuity, still the earnings, in so far as she was entitled to them, would have been hers, and, consequently, taxable to her.

Commissioner v. Olds, 60 F. (2d) 252 (C. C. A. 6).

In addition, there is a presumption that the findings of the Commissioner are correct. This is the usual presumption in favor of the legality of the acts of public officials.

Avery v. Commissioner, 22 F. (2d) 6 (C. C. A. 5);

Merchants etc. Co. v. Burnet, 49 F. (2d) 56 (C. C. A. 4);

Williams v. Commissioner, 45 F. (2d) 61 (C. C. A. 5);

Brooks v. Commissioner, 35 F. (2d) 78 (C. C. A. 4).

When the Commissioner makes two determinations, one at variance with the other, the later presumption prevails, for—

> "There is a presumption that he performed his duty, that is, that he acted upon all of the facts before him, *including new and different ones. United Staies v. Chemical Foundation,* 272 U. S. 1, 14, 47 S. Ct. 1, 71 L. ed. 131. This presumption of the existence of such new facts is not inconsistent with the presumption attaching to the first assessment, that the Commissioner acted upon all of the facts then before him."

Austin Co. v. Commissioner, 35 F. (2d) 910 (C. C. A. 6).

The Commissioner, as to the taxes for 1925 and 1926, permitted the payments to Mrs. Halton to be returned as a proprietary participation by her.

The court below suggests no reason why the payment made to Mrs. Halton should not be returned to her as a participation by her. Neither did the Board. The fact that the contract was supported by a consideration would not make the payment a capital expenditure. A capital expenditure means that money which has come to the taxpayer and belonged to him is spent by him to acquire something. But if by con-

tract—as a partnership contract or other participating contract—the flow of income is intercepted before it gets to the taxpayer, it never becomes his and cannot be a capital expenditure by him, even if he did receive a consideration for entering into the contract.

CONCLUSION.

It is respectfully submitted that both of the matters presented here present questions affecting taxpayers other than the petitioner, and that the matters here presented should be determined by this court because of their inherent importance, and to the end that there shall be uniformity among the circuits.

Dated at San Francisco, California, June 12th 1933.

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